Testimony of Jon A. Anda

April 24, 2009

Thank you for the opportunity to testify before this Committee today. My name is Jon Anda and I am a Visiting Fellow of the Nicholas Institute for Environmental Policy Solutions at Duke University. I was previously President of the Environmental Markets Network at EDF. During the past 2 and ½ years, at both Duke and EDF, I have worked to create a framework for the U.S. carbon market that is fair, equitable, and cognizant of lessons learned in the recent financial crisis. Prior to that time, from 1986 through 2006, I was with Morgan Stanley where I served in a variety of roles including Vice Chairman, Global Head of Capital Markets, Head of Corporate Finance, and Head of both the Institutional Equity and Investment Banking Divisions for the Asia Region.

I will keep my comments targeted to three critical issues, though I would note that the entire carbon markets section sets the right tone for fairness and efficiency in a post-financial crisis world. The three are as follows:

1. The Bill's provision of a best execution requirement for allowances is a critical provision – and I will comment on the means of achieving this.

2. The Bill's requirement of designated contract markets, or DCM's, for allowance derivatives trading, is the right decision – and I will highlight a few issues related to what is, arguably, the most important carbon markets provision in the Bill.

3. The opposition to the Bill's carbon markets provisions may be well intentioned, but opposing concerns can be addressed within the Bill's current framework – and I will discuss a few examples of this.

Before covering each of these, let me give a short "situation overview" of the starting point for the U.S. carbon market:

1. The Bill provides for 131 billion allowances over the life of the policy, although as few as 5 billion may be outstanding initially. Additionally, many of these 5 billion will simply be purchased at auction and submitted for compliance. Therefore, the so-called "float" of outstanding allowances will be quite small relative to the total. This will drive demand for derivatives as an outlet for risk management. Put another way, we are asking emitters to take on 38 years of abatement with as few as 1 year of allowances available to manage risk. At least initially, this means derivatives will be the "tail wagging the dog" in U.S. carbon trading - and highlights the importance of the Committee's firm stand on listed and transparent trading of derivatives.

2. At a minimum, the Government may need to resolve a technical issue so that DCM-traded derivatives are linked to the physical supply of allowances. You all remember, I'm sure, when the notional value of credit default swaps got to over

$70 trillion - far larger the value of the underlying credit instruments. For efficient listed derivative markets the Government may need to explicitly guarantee that some unsold future allowances will be distributed ahead of listed derivative contract expiration dates.

3. As covered in the Bill, selling up to 4 future vintages upfront is a means to expand the allowance float. But this will tend to create auction sizes too large to be executed efficiently. Another way to expand the initial float is, to the degree that any allowances will be freely allocated, front-end loading allocated allowances to facilitate a more liquid and stable allowance market. Lastly, the Government could simply add Allowance Purchase Rights (APR's) to the regular allowance auctions. The APR's would allow for fixed price purchase of allowances in, say, 4 years time. The APR's could be a useful exchange-traded hedging tool with physical delivery of allowances assured - as well as effectively providing financing to emitters since the exercise price isn't paid until expiration.

With that as background, let me come back to the comments I want to make about best execution, DCM's, and opposition to these types of provisions:

1. Best execution means that when you buy or sell an allowance you are assured of getting the best price available across all potential trading venues. This is critically important because carbon prices flow quickly through to consumer's prices - and not all emitters have the capability to arbitrage across non-linked markets. The

question is this: at what point is the National Market System, as required by the Bill, too cumbersome relative to a single electronic Central Limit Order Book (or CLOB)? NYSE Euronext, for example, lists 8,500 stocks worth about $16 trillion in value, trading over $150 billion per day. Competition is arguably good to keep the NYSE's pricing in line. Yet carbon is closer to a single instrument than it is to 8,500 stocks. So the Commission might want to consider the alternative, at least during the initial years, of having the Regulator outsource (through an RFP process) operation of a "CLOB for carbon" to a qualified private exchange.

2. The Bill's broad definition of carbon derivatives, and the requirement to trade them on regulated DCM exchanges, is an effective means of achieving fairness and efficiency. This is particularly the case in the early years when the allowance float will be small and demand for derivatives will be high. I want to suggest a quid pro quo, though, for mandating allowance derivative trading on exchanges – which is rational accounting treatment for the emitters and project developers who use them. Let me explain this a bit further. Sometimes corporations use structured OTC instruments to avoid mark-to-market accounting of listed futures or options. They do this is because mark-to-market makes their earnings less predictable. It seems that emitters should be able to hold futures and options with physical delivery and treat them as simply a deferred expense - *provided their intention is to submit the underlying allowance for compliance*. If all DCM listed instruments had to be marked-to-market on emitter's balance, regardless of intent to submit for

compliance, then the Committee might be forced by emitters and project developers to reconsider allowing the OTC market to operate more freely. As an aside, the accounting issue could also constrain banking if all allowances have to be marked to market.

3. Lastly, I'll make 4 brief points about opposition to the best-execution and DCM aspects of the carbon markets section. First, we all recognize that unrestricted markets are theoretically the most efficient – yet if we expose a market (particularly a new one) to systemic risk then the efficiency benefit might be overwhelmed by systemic risk. We certainly saw this in markets like sub-prime mortgages and credit default swaps. In the case of climate policy, systemic risk in the carbon market might necessitate easing the policy, thereby going back to systemic risk in the atmosphere and negating one of the Bill's stated objectives. Secondly, as to the concern about longer term derivative trades that need to be negotiated between 2 parties - there is no reason that trades can't be arranged off-exchange by two parties, and then "printed and cleared" on an exchange (as happens in the normal course on most exchanges). Third, while the Bill constrains highly customized bi-lateral arrangements, the Commission can consider the degree to which such arrangements, if at least partially cleared on a registered exchange, can have an acceptable degree of residual bi-lateral risk and still be transacted. Lastly, it is not clear that the Bill is applicable to OTC trading of "pre-

approval" offset credits – and this is an area where OTC trading might, in fact, be more appropriate.

I would like to make one final point about opposition to the DCM provision in the Bill. The vehemence of this opposition might raise a concern about development of OTC markets outside of U.S. jurisdiction. One means of minimizing the impact of such activities would be to say that if someone wants to be a member of a registered U.S. carbon exchange then the "bar is raised" on their offshore trading so as to achieve transparency and limit counterparty risk (i.e. requiring disclosure and U.S. exchange clearing). This would strengthen the principals-based regulation in the Feinstein-Levin-Snowe amendment to last year's Farm Bill.

Thank you for allowing me, with the support of my colleagues from the Nicholas Institute, to provide input to this Committee. I look forward to answering your questions.